The Ethics of Non-Equity Partners at California Law Firms

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Law firms are increasingly creating income or non-equity "partners." With a slowing economy, law-firm partnerships look to increase their profitability per partner, while not alienating senior associates. As a result, more law firms are adopting an income-partner position. Paradoxically, many non-equity partners are earning more than if they were equity partners, because equity partners' income generally decline in a slow economy, whereas non-equity partners receive a fixed guaranteed amount. Hiring non-equity partners is a relatively recent phenomenon and, unfortunately, many firms do not properly consider the ramifications it will have on the partnership or on partnership law. This article examines the treatment of non-equity partners and concludes that firms having non-equity partners and identifying such persons as "partners" may violate rule 1-400 of the California Rules of Professional Conduct, which generally prohibits communications or solicitations containing untrue statements. This article considers whether non-equity partners are partners under California law and whether calling them "partners" violates rule 1-400.

What is an Income or Non-Equity Partner?

California partnership law does not mention or even define an income or non-equity partner. In fact, the Corporations Code does not define the term "partner," but rather defines "partnership" as an association of two or more persons who carry on as co-owners of a business conducted for profit.[1] Although the question of whether a partnership exists generally depends upon the intent of the purported partners,[2] a partnership can be found to exist even if the co-owners had no intent to form one.[3] This is because the conduct of certain activities specifically indicates the existence of a partnership.

In determining whether a partnership is formed, the following rules apply: [4]

(1) Joint tenancy, tenancy in the entireties, joint property, community property or part ownership within property, does not by itself establish a partnership, even if the co-owners share in profits made from use of the property.

(2) The sharing of gross returns does not by itself establish a partnership, even if the persons sharing therein have a joint right or interest in the property from which the returns are derived.

(3) A person who receives a share of business profits is presumed to be a partner, unless the profits were received for any of the following reasons: (a) As payment for a debt owed to the recipient (by installment or otherwise); (b) as payment for services rendered by the recipient as an independent contractor or employee; (c) as a rent payment; (d) as payment for an annuity or other retirement benefit due to a beneficiary, representative, or designee of a deceased or retired partner; (e) as payment of a loan charge such as interest fees, even if the amount of the payment varies with the profits of the business, including the way to direct or indirect present or future ownership of a collateral, rights to income or proceeds or increase in value derived from the collateral; and (f) as payment for the sale of goodwill of the business or other property made by installments.

Generally, when defining a partnership, the relevant inquiry has been whether two or more persons co-own property in a business. Co-ownership of property, profit sharing, participation in management, control, and capital contributions generally indicate the existence of a partnership.[5] Thus, the attributes of a partnership can be summarized as follows:

(i) Co-ownership of property;
(ii) Division of profits;[6]
(iii) Participation and Control;
(iv) Loss sharing; and
(v) Contributions to the capital of the enterprise.

The typical income or non-equity partner does not hold most, or sometimes any, of these attributes. Income partners often have fixed compensation and a bonus arrangement, but do not share in the profits and losses of the firm. Income partners generally do not vote on partnership matters and are often not eligible to participate in partnership executive or management committees. In a few firms, non-equity partners make contributions to capital, but—on average—income or non-equity partners do not make any contributions and do not have capital accounts for purposes of section 704 of the Internal Revenue Code (26 U.S.C. § 704).[7] Finally, income partners normally have no co-ownership of partnership property. This is reflected when they leave or withdraw from the business, because they do not receive any capital account.

Consistent with this discussion, the California Supreme Court, in *Chambers v. Kay,* [8] looked at a fee-splitting arrangement, where the defendant argued that he was a partner of the plaintiff for purposes of rule 2-200 of the California Rules of Professional Conduct, and thus was entitled to split fees with him. Rule 2-200 permits an attorney to split fees with his partners without having first received the client's consent to do so. Like their Corporations Code counterpart, however, the Rules of Professional Conduct fail to define the term "partner." To determine whether Mr. Chambers was, in fact, Mr. Kay's partner, the *Chambers* court looked to Corporations Code section 16202. In doing so, the Court found that the parties neither co-owned property, nor shared in profits and losses. Accordingly, the parties could not be considered partners for purposes of rule 2-200. Fee splitting was thus not permitted without client consent.

The opinion reached in *Chambers* is consistent with the State Board of Equalization's decision in *Jansonius v. State Board of Equalization.* [9] In *Jansonius*, the taxpayer was a "special partner" in McKenna and Cuneo's Dallas office. As a special partner, the taxpayer received a base salary and was entitled to receive a performance bonus. He was not, however, considered an equity partner of the firm. As such, the taxpayer had no right to share in the firm's profits or losses, had no responsibility for debts or obligations of the firm, and was not permitted to participate in firm management. It was expected that the taxpayer would become admitted as an equity partner at some future time.

In reviewing whether the taxpayer was a partner of the firm, the State Board of Equalization found that, although he was something more than a traditional associate, he was less than a co-owner of the firm. He had no interest in firm property, and had no right to share in the firm's profits and losses. Because he possessed neither of these attributes that define partner standing, the State Board of Equalization determined that he was not a partner of the firm for California income tax purposes.

Ethical Restrictions on Income or Non-equity Partners

Generally, rule 1-400 prohibits attorneys from making any communication or solicitation that includes any untrue statement or contains any matter which is false or deceptive (including presenting or arranging any matter), or that tends to confuse, deceive, or mislead the public. Rule 1-400(A) defines a "communication" as "any message or offer made by on or on behalf of a member concerning the availability for professional employment of a member or a law firm" that is directed to "any former, present, or prospective client." Communications include stationery, letterhead, business cards, brochures, or other materials that describe a member, law firm, or lawyers. Rule 1-400(A) defines the term "solicitation" as any form of communication that concerns "the availability for professional employment of a member or a law firm in which a significant motive is pecuniary gain," that is "delivered in person or by telephone" or "directed by any means to a person known to the sender to be represented by counsel in a matter which is a subject matter of the communication."

Certain forms of communication are presumed to violate rule 1-400. Specifically, a "communication" containing a firm name, trade name, fictitious name, or other professional designation that states or implies that a member has a relationship to any lawyer or law firm as a *partner* (emphasis added), associate, officer, or shareholder pursuant to sections 6160 through 6172 of the Business and Professions Code, violates rule 1-400, unless such relationship actually exists. Thus, a member cannot hold out herself or himself as a partner of another member of a law firm, unless that individual is an actual partner of the other member or of the firm (and vice versa).

Because California law does not generally recognize an income partner as a partner, it seems logical to conclude that referring to a non-equity partner as a "partner" could violate rule 1-400. Such a conclusion makes sense when one considers that calling an employee a "partner" would likely be seen as misleading to the general public.

In addition to the possible ethical violations that could result from presenting an income or non-equity partner to the public as a partner, doing so could result in unexpected liability for either (i) the member or firm presenting said person as a partner; or (ii) the person being so presented. If a person, by words or conduct, purports to be a partner or permits another person to identify him as such, he or she can be held liable to any person to whom such representation is made if that person, relying on such representation, enters into a transaction with the purported partner to her detriment.[10] If either the purported partner or the person who holds him out as such makes such representation in a public fashion, the purported partner can be held liable to any person who detrimentally relied upon such representation, even if the purported partner was not aware that such representation was being made.

Where partnership liability results from improper characterization, the purported partner can be held liable to the firm as though he or she was an actual partner of the firm. Where no partnership liability results, the purported partner can still be held jointly and severally liable by any member who consented to the representation. Thus, an individual holding himself out as a partner, or allowing others to do so, can create or become liable for partnership debts. Corporations Code section 16308 might apply to limit that liability.

Corporations Code section 16308 is based upon section 308 of the Revised Uniform Partnership Act ("RUPA") and is

Continued on Page 12